18.01 Cash Flow Activities

> The statement of cash flows is consistently tested on the CPA exam, usually as either several multiple-choice questions or as part of a simulation.

The statement of cash flows is a **required** financial statement whenever a company is presenting the results of operations for a year (ASC 305). The primary **purpose** is to provide detailed information about an entity's cash inflows and outflows (Sources and Uses). We are also interested in their Investing and Financing activities.

In the statement of cash flows, we measure the change in cash and **cash equivalents**. A Cash equivalent is a financial instrument that is *both*:

- Easily convertible into a known amount of cash (**highly liquid**), and
- **Original maturity of 3 months or less** from the date of purchase. Since it is so close to maturity, this presents very little risk of change in value, due to changes in interest rates. (Eg, Treasury bills, commercial paper, and money market funds)

There are **three categories of activities** in the statement of cash flows:

- **Operating activities** – Inflows and outflows of cash related to the production of income from continuing operations. All transactions that are NOT investing and financing activities are considered operating.
  - Collections on sales from customers
  - Cash payments for COGS and SGA
  - Interest received and paid
  - The portion of a settlement of zero-coupon debt instruments attributable to the accreted interest related to the debt discount.
  - Dividends received
  - Acquisition and disposal of trading securities
  - Payments for income taxes
  - All other receipts/disbursements that do not stem from transactions defined as Investing or Financing activities.
- **Investing activities –** Investing in yourself or others.
  - Principal collections or **L**oans made by the entity (interest and dividends received are Operating)
  - Acquisition or disposal of available-for-sale or held-to-maturity **I**nvestments (Not Trading)
  - Acquisition or disposal of **P**roperty, plant & equipment, and intangibles
  - Cash received in settlement of corporate-owned life insurance policies
  - Cash received from payments on receivables transferred in exchange for a beneficial interest in a securitized transaction

Acquisition		
PP&E	47	
Cash		47

Disposal		
Cash	15	
Accumulated Depreciation	37	
Equipment		47
Gain on sale		5

- **Financing activities** – Issuing Debt or Equity
  - Proceeds from issuing or payments for retiring Bonds (interest is Operating)
  - Issuance or Reacquisition of stock or Treasury stock
  - Borrowing or repaying a loan
  - Debt prepayment or debt extinguishment costs
  - The portion of a settlement of zero-coupon debt instruments attributable to principal
  - Dividends paid to shareholders (dividends received is Operating)

Examples of Financing activities		
Cash	X	
Common stock		X
Preferred stock		X
APIC		X
N/P		X
Bonds Payable		X

The classification of some items is determined based on the nature of the payment and the circumstances under which it is received or paid. For example:

- Contingent consideration related to a business combination that is paid in a period after that of the business combination:
  - If made soon after the acquisition, it is an outflow for investing activities

If paid to settle a contingent consideration liability that was recorded at the acquisition date, it is an outflow for financing activities to the extent that it reduces the contingent liability with any excess classified as an outflow for operating activities.

- Cash proceeds from the settlement of insurance claims are classified on the basis of the nature of the loss.
- Cash payments for insurance premiums on corporate-owned policies may be reported as outflows for investing activities, for operating activities, or some combination of the two.

- Distributions from equity method investments may be treated using either of two approaches:
  - Under the **cumulative earnings approach** – distributions received are cash inflows from operating until the cumulative amount recognized equals the cumulative equity in earnings recognized by the investor. Any excess is an inflow from investing activities.
  - Under the **nature of distribution approach** – distributions are classified based on the nature of the activity that generated the distribution, with returns **on** investment classified as cash inflows from operating activities and as cash inflows from investing activities when a return **of** investment.

Cash receipts and payments that have characteristics associated with more than one classification may be subject to specific requirements identified in the FASB Accounting Standards Codification, indicating how they should be classified on the statement of cash flows. If not, cash flows related to each separately identifiable source should be classified based on the nature of the underlying cash flows. When cash flows with characteristics of more than one classification cannot be separated by source, they should be classified based on the most predominate characteristic.

Roger Company
Statement of Cash Flows
FYE December 31, 20X3

	Dr.	Cr.	Change
Cash flows from **Operating** activities			
Net cash *provided (used)* by operating activities			**$135**
Cash flows from **Investing** activities			65
Net cash provided (used) by investing activities			
Cash flows from **Financing** activities			
Net cash provided (used) by financing activities			(50)
Net Increase or Decrease in cash			$150
+ **Beginning** cash balance			+100
Ending cash balance			$250